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Response by the Riksbank to the European Commission's call for evidence on Directive 2003/6/EC on insider dealing and market manipulation (MAD)

Issues related to the prevention of market abuse are not the responsibility of Sveriges Riksbank. However, smoothly functioning financial markets affect the Riksbank's task to preserve financial stability. The ability of market participants to enter into short positions contributes to the smooth functioning of the financial system. Therefore, the Riksbank has answered only those questions relating to short selling of stocks.

2.3.4 Short selling

Question: Do you see a need for a comprehensive framework for short selling? If so should it be addressed in the Market Abuse Directive? What issues should a regime cover?

There is no need for a comprehensive framework on short selling. The benefits of short selling clearly outweigh the drawbacks. Short selling allows investors with a negative view on the value of a company to take a position that reflects that view. By doing so their information will be incorporated in the prices and thus, the price formation will be more efficient. These investors will by trading also contribute to a higher liquidity. Both these effects increase market efficiency. What could be considered is to implement a more harmonised framework for short selling in the European financial markets to decrease uncertainty and increase market transparency.

Question: Should short sellers be required to report positions to competent authorities?

A higher transparency in the market place makes it easier for supervisory authorities to manage market abuse. Hence, large short positions could be reported to competent authorities.

Question: Under which conditions should naked short selling be allowed?

Naked short selling is not a problem as long as market participants make sure not to fail on delivery. Hence, instead of banning naked short selling, market regulators should focus on implementing a regulatory framework that minimises incentives to fail on delivery.

Question: Should competent authorities be able to take emergency measures (e.g. temporary bans on short selling or on naked short selling) within prescribed limits when they need to address specific market risks and disruptions?

The evidence shows that temporarily banning short selling does not have the desired effects on financial markets. A ban may at best delay a fall in stock prices but the effect is limited since market participants can take a short position in the market using other financial instruments, such as options or futures. Instead a ban has a negative effect on the price formation, liquidity and efficiency of financial markets. Given the difficulties in deciding in what situation a ban should be imposed, it only creates uncertainty in financial markets, which in turn has a negative effect on market efficiency.

Question: Is there need to enhance risk management by financial intermediaries and banks?

It is important that financial intermediaries and banks have sufficient intraday risk management systems to make certain that all positions at the end of the day are covered with the underlying securities and thus, that failures are avoided. Also, it is of importance that banks and intermediaries perform stress tests of their positions as part of their risk management procedures.

Question: Should investment firms and banks be required to have necessary arrangements in place to ensure timely delivery of financial instruments traded on own account or in the context of execution of clients' orders?

Failure to deliver disrupts markets and decreases confidence between market participants. Hence, they should be kept at a minimum level. If financial intermediaries can implement a framework that ensures timely delivery, that would be desirable. However, before enforcing regulation, the willingness of banks to self-regulate such an issue should be investigated.

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